Cassels

The Challenges of Regulating Cryptocurrency and Decentralized Finance

Dr. Alison R. Manzer, Sean Maniaci, Danielle DiPardo, Steven Henderson

October 12, 2021

INTRODUCTION

As the world of cryptocurrency and decentralized finance (DeFi) rapidly develops, tensions and debates between financial regulators and the cryptocurrency community continue to gain relevance. These tensions flared up recently in the United States after the cryptocurrency exchange platform Coinbase Global Inc. (Coinbase) canceled its anticipated peer-to-peer crypto lending program called “Lend”. Coinbase reported that the SEC issued a Wells notice, threatening to bring an enforcement action against the company if they launched Lend as they deemed the product to be dealing securities. Coinbase further alleged that the SEC did not provide an explanation as to how it had determined that the Lend program involves securities or identify any specific concerns with the Lend program.

Since Coinbase is the first major cryptocurrency exchange platform to go public in the U.S., this development re-ignited the debate over the ability of current securities laws to effectively govern cryptocurrency and DeFi offerings, as well as larger policy debates regarding the role of traditional financial regulators in the crypto industry.

THE LEGAL BACKGROUND: THE CHALLENGE OF APPLYING SECURITIES LAWS TO CRYPTOCURRENCY AND DEFI

One of the main questions underlying the tensions between the crypto industry and financial regulators is whether crypto-based instruments, such as cryptocurrency coins, tokens and other offerings backed by these coins or tokens, meet the definition of a “security” under securities law. In both Canada and the U.S., securities regulators have broad authority to regulate instruments that meet the legal definition of a “security” (and distributions of such securities to the public) and subject distributors of these instruments to disclosure requirements, registration requirements and other forms of regulatory oversight. Regulators must balance investor freedom of access to this new form of financial technology versus protecting investors from concerns such as token price volatility, transparency, valuation, custody and liquidity, as well as the use of unregulated cryptocurrency exchanges.

In 2017, the Canadian Securities Administrators (CSA) published a staff notice[1] stating that when determining whether a cryptocurrency offering meets the definition of a "security", the archetypical four-step test from the Supreme Court of Canada case *Pacific Coast Coin Exchange v. Ontario Securities Commission*[2] for defining an "investment contract" should apply. Particularly, an investment contract is: (1) an investment of money; (2) in a common enterprise; (3) with the expectation of profit; (4) that is to come significantly from the efforts of others. In considering whether or not securities laws apply to a given coin/token, the CSA has stated that they will consider substance over form.

In January 2020, the CSA published a staff notice[3] confirming that securities legislation would apply to some crypto entities, thus triggering the registration requirement applicable to all public issuers. Then, in March 2021, the CSA published a staff notice[4] providing further clarity on how to satisfy registration requirements. The March 2021 staff notice also acknowledged the need for, and recommended adopting, an interim approach toward crypto trading platforms being required to register as an investment dealer with IIROC given the length and complexity of this registration process.

ARGUMENTS FOR STRICTER REGULATION OVER CRYPTOCURRENCY AND DEFI

Proponents of stricter regulation argue that cryptocurrency exchanges may constitute "common enterprises", that purchasers of crypto-based offerings now do so with an expectation of profit, and that this profit is often tied to external behaviour such as business activities and coordinated marketing efforts.

In recent months, SEC Chair Gary Gensler has repeatedly emphasized the need for cryptocurrency and DeFi platforms to fall under SEC regulation to ensure that investors who use these platforms are adequately protected.[5] Mr. Gensler, as well as others in favour of bringing these platforms under SEC regulation, have expressed concerns that the cryptocurrency and DeFi industries, if left unregulated, are open to fraud and abuse, thus further leaving investors unprotected from these risks. Disclosure requirements, registration requirements, and the use of sanctions have been suggested as necessary to achieve important policy goals, including anti-money laundering, tax compliance, and keeping investors informed of the risks of their investments. Mr. Gensler has also advocated for the U.S. Congress to update relevant legislation to allow the SEC to more closely collaborate with other financial regulatory bodies to ensure that the unique challenges and risks that crypto and DeFi present are appropriately managed.[6]

ARGUMENTS FOR LOOSER REGULATION OVER CRYPTOCURRENCY AND DEFI

The crypto community at large mostly opposes strict regulation on the industry, as one of the main

advantages of blockchain finance is the removal of centralized control of money from government agencies. They argue that such regulation is unnecessary, or even harmful, when applied to these new, innovative offerings. In addition, they argue that regulators should not attempt to force new technology to fit into archaic legislation and caselaw which never anticipated these types of offerings. The seminal U.S. securities legislation were enacted in the 1930s, and many of the key cases that continue to be applied in interpreting these laws were decided in the 1940s and 1950s.

This argument is especially prevalent when it comes to DeFi platforms and offerings, which are intended to provide peer-to-peer lending, banking and financial services backed by blockchain technology to bypass the need for a centralized intermediary to oversee exchanges. While most platforms currently labelled as DeFi platforms are not yet truly decentralized (such as Coinbase's Lend, for which Coinbase acts as an intermediary), DeFi enthusiasts are confident that fully decentralized finance is imminent. As a result, they argue that these platforms do not fit under traditional securities laws, as most securities legislation and caselaw assumes the existence and regulatory functions of intermediaries.

Following the SEC's response to Coinbase in issuing a Wells notice, some DeFi advocates have argued that subjecting Coinbase to the SEC regulatory regime is illogical because DeFi presents less vulnerabilities and security risks than traditional finance options. While traditional finance faces the risk of widescale leaks if the centralized intermediary is hacked, DeFi proponents argue that the blockchain-backed, decentralized nature of DeFi platforms make similar hacks and leaks impossible. Others have argued that current disclosure requirements and other regulatory efforts are not sufficiently forward-looking or accessible to the average investor, so attempting to force these already flawed requirements onto fundamentally different offerings will not meet the SEC's stated policy goals. Some DeFi and cryptocurrency enthusiasts have gone as far as arguing that subjecting these offerings to traditional securities regulation would actively harm investors by restricting their ability to utilize the latest investment technologies and by encouraging the creators of these platforms to use more questionable methods to avoid regulation, such as remaining anonymous or relocating to other countries.

CONCLUSION

Determining whether a crypto-based offering legally constitutes a "security" is one of the central questions in the regulatory debate, but additional legal questions remain. For example, even if a crypto-based offering meets the definition of a "security", there would need to be further determinations regarding whether the trading platforms for these instruments constitute a "marketplace", as different rules, regulations and National Instruments apply to platforms depending on whether or not they fall under this characterization.

As this industry rapidly grows, securities regulators have the task of keeping up with a constantly changing crypto environment. In the U.S., there are examples of progressive law makers trying to set the framework for a legal ecosystem that allows crypto to evolve, while protecting consumers. Recently, on October 5,

2021, Representative Patrick McHenry, the ranking member of the U.S. House Financial Services Committee, proposed a new bill called the *Clarity for Digital Tokens Act of 2021*[7]. This bill seeks to turn SEC Commissioner Hester Peirce's idea of a "safe harbour" for crypto assets into law. Under the proposed legislation, crypto companies could launch tokens without being offside of U.S. securities laws. Under the bill, crypto startups would have three years to become fully decentralized. After that, these companies would no longer be considered distributors of securities.

Although the debate surrounding the regulation of cryptocurrency and DeFi is complex and uncertain, the dilemma the SEC (and all other securities regulators) face is clear: balancing the protection of investors from new, potentially risky investment technology, while also ensuring it does not stifle innovation and deny investors access to a fast-growing industry that is likely to keep developing around the world. The SEC's decision to issue a Wells notice in response to Coinbase's proposed Lend program signals that the SEC may consider crypto-related assets to fall under securities laws. However, there is no clear indication as to whether the SEC has resolved this dilemma or if the SEC is preparing to release guidance on the regulation of cryptocurrency and DeFi.

As of now, the focus in this area has mostly been in the U.S. and on the SEC, with guidance beginning to be released from the CSA as well. Given the tendency of Canadian securities regulators to follow the U.S.'s lead on key regulatory issues, Canadian investors and distributors should keep a close watch on developments across the border, as they are likely to inform Canada's approach.

---

[1] "CSA Staff Notice 46-307: Cryptocurrency Offerings" <https://www.osc.ca/en/securities-law/instruments-rules-policies/4/46-307/csa-staff-notice-46-307-cryptocurrency-offerings>

[2] [1978] 2 SCR 112.

[3] "CSA Staff Notice 21-327: Guidance on the Application of Securities Legislation to Entities Facilitating the Trading of Crypto Assets" <https://www.osc.ca/en/securities-law/instruments-rules-policies/2/21-327/csa-staff-notice-21-327-guidance-application-securities-legislation-entities-facilitating-trading>

[4] "Joint CSA/Investment Industry Regulatory Organization of Canada Staff Notice 21-329: Guidance for Crypto-Asset Trading Platforms: Compliance with Regulatory Requirements" <https://www.osc.ca/en/securities-law/instruments-rules-policies/2/21-329/joint-canadian-securities-administratorsinvestment-industry-regulatory-organization-canada-staff>

[5] "The Path Forward: Cryptocurrency with Gary Gensler" (Washington Post) <https://www.washingtonpost.com/washington-post-live/2021/09/21/path-forward-cryptocurrency-with-gary-gensler-us-securities-exchange-commission-chair/>

[6] SEC Letter to Senator Elizabeth Warren <https://www.warren.senate.gov/imo/media/doc/gensler_response_to_warren_-_cryptocurrency_exchanges.pdf>

[7] https://republicans-financialservices.house.gov/news/documentsingle.aspx?DocumentID=408154

Cassels